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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-131756-11]

RIN 1545-BI49

Transactions Between Related Persons and Partnerships

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that would update regulations regarding whether persons are treated as related persons who are subject to certain special rules pertaining to transactions with partnerships. The regulations affect partnerships that enter into transactions with related persons that result in gain or loss on a sale or exchange of property or result in a difference in the time at which income and deductions are recognized because of the persons' different methods of accounting.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER PUBLICATION IN THE *FEDERAL REGISTER*]**. Requests for a public hearing must be submitted as prescribed in the "Comments and Requests for a Public Hearing" section.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at *https://www.regulations.gov* (indicate IRS and REG-131756-11). Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of Treasury (Treasury Department) and the IRS will publish any comments submitted electronically and comments submitted on paper to the IRS's public docket.

Send paper submissions to: CC:PA:LPD:PR (REG-131756-11), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations relating to section 267, Livia Piccolo, (202) 317-7007 (not a toll-free number); concerning the proposed regulation relating to section 707, Charles D. Wien, (202) 317-5279 (not a toll-free number); and concerning the submission of comments and requests for a public hearing, Vivian Hayes, (202) 317-6960 (not a toll-free number) or by sending an email to *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 267 and 707 of the Internal Revenue Code (Code) relating to the disallowance or deferral of deductions for losses and expenses in certain transactions with partnerships and related persons (proposed regulations). The proposed regulations would remove §1.267(b)-1(b) and amend §1.267(a)-1 to remove the application of Questions and Answers 2 and 3 in §1.267(a)-2T(c) for taxable years ending on or after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. In addition, the proposed regulations would amend §1.707-1(b).

In general, section 267(a)(1) provides that a taxpayer may not deduct a loss on the sale or exchange of property with a related person as defined in section 267(b). Section 267(a)(2) sets forth a “matching rule” that provides that if because of a payee’s method of accounting, an amount is not (unless paid) includible in the payee’s gross income, the taxpayer (payor) may not deduct the otherwise deductible amount until the payee includes the amount in gross income if the taxpayer and payee are related persons within the meaning of section 267(b) on the last day of the taxpayer’s taxable year in which the amount otherwise would have been deductible.

As part of enacting the Internal Revenue Code of 1954, Public Law 83-591, ch. 736, 68A Stat. 1 (1954), Congress added section 707(b)(1) to the Code to address the sale or exchange of property between a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital or profit interest in the partnership. 68A Stat. at 243. Given a lack of statutory and regulatory guidance addressing transactions between a partnership and a related person who was not a partner, the Treasury Department and the IRS issued §1.267(b)-1(b) in 1958. *See* TD 6312, 23 FR 7035 (Sep. 11, 1958).

Section 1.267(b)-1(b) applies an aggregate theory of partnerships to provide that any transaction described in section 267(a) between a partnership and a person other than a partner is considered as occurring between the other person and the members of the partnership separately. Specifically, §1.267(b)-1(b) provides that if the other person and a partner are within any of the relationships specified in section 267(b), no deductions with respect to the transaction between the other person and the partnership will be allowed: (i) to the related partner to the extent of the related partner's distributive share of partnership deductions for losses or unpaid expenses or interest resulting from the transactions, and (ii) to the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by the other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of the transaction.

The U.S. Tax Court upheld the validity of §1.267(b)-1(b) and its use of the aggregate theory in Casel v. Commissioner, 79 T.C. 424 (1982). However, subsequent statutory changes to sections 267 and 707(b) have made §1.267(b)-1(b) inconsistent with the statute.

In 1982, Congress enacted section 3(h)(1) of the Subchapter S Revision Act of 1982, Public Law 97-354, 96 Stat. 1669, 1689 (1982) to add section 267(b)(10) to the Code to disallow a deduction resulting from a transaction between a commonly-controlled partnership and an S corporation. Specifically, section 267(b)(10) provides that an S corporation and a partnership were related persons if the same persons owned more than 50 percent of the outstanding stock of the S corporation and more than 50 percent of the capital interest or the profits interest in the partnership.

In 1984, Congress enacted section 174(b)(1) of the Tax Reform Act of 1984 (TRA 1984), Public Law 98-369, 98 Stat. 494, 705 (1984), to add section 267(e) to the Code generally to extend the matching rule of section 267(a)(2) to transactions between a partnership and a partner or a person related to a partner (within the meaning of sections 267(b) or 707(b)(1)). Congress also enacted section 174(b)(3) of the TRA 1984, 98 Stat. at 707, to amend section 267(b)(10) to include C corporations as well as S corporations.

In 1985, the Treasury Department and the IRS issued §1.267(a)-2T(c) to provide guidance for transactions between related partnerships. Consistent with the legislative history of the TRA 1984, the regulations generally apply an aggregate theory of partnerships in deferring deductions according to the partners' aggregate interests in the payor partnership. *See* S. Rep. No. 98-169, 98th Cong., 2nd Sess., at 496 and n. 17 (1984); TD 7991, 49 FR 46992 (Nov. 30, 1984).

In the Tax Reform Act of 1986 (TRA 1986), Public Law 99-514, 100 Stat. 2085 (1986), Congress amended section 707(b) in two ways. First, Congress revised sections 707(b)(1)(A) and 707(b)(2)(A) to expand the application of those provisions to a person who is not a partner and modified section 707(b)(2) to reduce the thresholds described in that section from more than 80 percent of profits or capital to more than 50 percent of profits or capital for purposes of treating recognized gain between related persons as ordinary income. As amended by section 1812(c)(3) of the TRA 1986, 100 Stat. at 2834, the loss disallowance rules of section 707(b)(1)(A) and the character of gain rules of section 707(b)(2)(A) apply to transactions between a partnership and any person (a partner or non-partner) who directly or indirectly owns more than 50 percent of the capital or profits interest in the partnership. *See* sections 707(b)(1)(A), (b)(2)(A), and (b)(3).

Second, in enacting section 642(a)(2) of the TRA 1986, 100 Stat. at 2284, Congress amended section 707(b)(1)(B) to provide that for purposes of the matching rule in section 267(a)(2), two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests are treated as related persons within the meaning of section 267(b). The related committee reports state that the modifications to section 707(b), and in particular to section 707(b)(1)(B), were intended to replace Questions and Answers 2 and 3 of §1.267(a)-2T(c). *See* H. Rept. No. 99-426, 99th Cong., 1st Sess., at 940 and n. 7 (1986), 1986-3 C.B. Vol. 2, at 940 and n. 7; S. Rep. No. 99-313, 99th Cong., 2nd Sess., at 960 and n. 7, 1986-3 C.B. Vol. 3, 959, 960 and n. 7.

Explanation of Provisions

The statutory changes to sections 267 and 707(b) enacted since 1982 indicate that Congress intended for a partnership to be viewed as an entity, rather than as an aggregate of its partners, in applying the rules of sections 267 and 707(b). Therefore, the loss disallowance rules of sections 267(a)(1) and 707(b)(1), the gain recharacterization rules of section 707(b)(2), and the matching rule of section 267(a)(2) similarly should be applied at the partnership level and not the partner level. Accordingly, the rules relating to partnerships in §1.267(b)-1(b) and §1.267(a)-2T(c), Questions and Answers 2 and 3, do not conform to Congress's view of how section 267 should be applied to partnerships.

To conform the regulations under section 267 with the current statute, the proposed regulations propose: (1) to remove §1.267(b)-1(b), (2) to amend §1.267(a)-1 to reflect the rules in Questions and Answers 1 and 4 in §1.267(a)-2T(c) as §1.267(a)-1(d)(2) and (3); and (3) to amend §1.267(a)-1 to terminate the application of Questions and Answers 2 and 3 in §1.267(a)-2T(c). The regulations under §1.267(a)-2T(b), which provide questions and answers applying section 267(a)(2) and (b) generally, would continue to apply. The Treasury Department and IRS are aware that some of the citations in the existing regulations under section 267 may be outdated due to subsequent legislative and regulatory changes. However, the rules in these questions and answers remain substantively accurate. For example, Question 1 under §1.267(a)-2T(b) refers to the completed contract method under §1.451-3(d). The substance of this answer remains correct; however, the correct citation to the completed contract method is now under §1.460-4(d). Modifications to update incorrect citations in §1.267(a)-2T(b) are outside the scope of these proposed regulations. Finally, these proposed regulations also revise §1.707-1(b) to conform to the statutory changes made to sections 267 and 707(b).

Proposed Applicability Date

These regulations are proposed to apply to taxable years ending on or after the date the Treasury decision adopting these rules as final regulations is published in the *Federal Register*. Thus, §1.267(b)-1(b) would be removed, and the revisions to §1.267(a)-1 would apply to taxable years ending on or after the date the Treasury decision adopting these rules as final regulations is published in the *Federal Register*. Similarly, the revisions to §1.707-1(b) would apply to sales or exchanges of property with respect to controlled partnerships in taxable years ending on or after the date the Treasury decision adopting these rules as final regulations is published in the *Federal Register*.

Special Analyses

I. Regulatory Impact Analysis

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. Paperwork Reduction Act

These proposed regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements, or third-party disclosure statements. However, a taxpayer may continue to be required to report on Form 1065, *U.S. Return of Partnership Income*, information about partners that own directly or indirectly more than 50 percent of the partnership. Data on the number of affected taxpayers is not available.

For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(c)) (PRA), the reporting burden associated with the collection of information for Form 1065 will be reflected in the PRA submission associated with the income tax returns under the OMB control number 1545-0123.

The overall burden estimates associated with the OMB control number 1545-0123 is an aggregate number related to the entire package of forms associated with the applicable OMB control number and will include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of these proposed regulations. These numbers are therefore not specific to any burden imposed by these proposed regulations. The burdens have been reported for other income tax regulations that rely on the same information collections and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burdens imposed by tax provisions prior to the Act. No burden estimates specific to the forms affected by the proposed regulations are currently available. For the OMB control numbers discussed in this paragraph, the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type-basis rather than a provision-specific basis. Those estimates capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations (when final) and other regulations that affect the compliance burden for that form.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize paperwork burden. In addition, when available, drafts of IRS forms are posted for comment at *https://appsirs.gov/app/pickleist/lit/draftTaxForms.htm*. IRS forms are available at *https://www.irs.gov/forms-instructions*. Forms will not be finalized until after they have been approved by OMB under the PRA.

III. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) (RFA) imposes certain requirements with respect to Federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551 *et seq.*) and that are likely to have a significant economic impact on a substantial number of small entities. The Treasury Department and the IRS certify that this proposal will not have a significant economic impact on a substantial number of small entities. The proposed regulations would remove certain outdated regulations under section 267 that apply an aggregate theory of partnerships and relocate other regulations that are not intended to be obsoleted. These regulations would preserve the status quo by updating the existing regulations to reflect the currently effective statutory provisions. Accordingly, this proposal is unlikely to have a significant economic impact on any small entities affected. The Treasury Department and the IRS invite comments on the impact on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel of the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, nor does this rule include any Federal mandate that may exceed the threshold for the private sector.

V. Executive Order 13132: Federalism

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial, direct compliance costs on State and local governments or preempt State law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “ADDRESSES” section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations.

Any electronic and paper comments submitted will be available at *https://www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the *Federal Register*. Announcement 2023-16, 2023-20 I.R.B. 854 (May 15, 2023), provides that public hearings will be conducted in person, although the IRS will continue to provide a telephonic option for individuals who wish to attend or testify at a hearing by telephone. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal author of these proposed regulations is Livia Piccolo of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in the development of the regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Par. 2. Section 1.267(a)-1 is amended by adding new paragraphs (d) and (e) to read as follows:

§1.267(a)-1 Deductions disallowed.

* * * * *

(d) *Rules for partnerships under the Tax Reform Act of 1984*--(1) *In general*. Paragraphs (d)(2) and (d)(3) of this section provide rules under section 267(a) and related provisions, as amended by section 174 of the Tax Reform Act of 1984, Public Law 98-369, 98 Stat. 494, 705 (1984), applicable specifically to partnerships for taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER]. Section 1.267(a)-2T(c) does not apply to taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER].

(2) *Application of section 267(a) to disallow losses and defer otherwise deductible amounts at the partnership (entity) level*. If a loss realized by a partnership from a sale or exchange of property is disallowed under section 267(a)(1), that loss does not enter into the computation of the partnership's taxable income. If an amount that otherwise would be deductible by a partnership is deferred by section 267(a)(2), that amount does not enter into the computation of the partnership's taxable income until the taxable year of the partnership in which falls the day on which the amount is includible in the gross income of the person to whom payment of the amount is made.

(3) *Application of section 267(e)(5)(C)(ii)*. The phrase *incurred at an annual rate not in excess of 12 percent* in section 267(e)(5)(C)(ii) refers to interest that accrues but is not includible in the income of the person to whom payment is to be made during the taxable year of the payor. Thus, in determining whether the requirements of section 267(e)(5) (providing an exception to certain provisions of section 267 for certain expenses and interest of partnerships owning low income housing) are met with respect to a transaction, the requirement of section 267(e)(5)(C)(ii) will be satisfied, even though the total interest (both stated and unstated) paid or accrued in any taxable year of the payor taxpayer exceeds 12 percent, if the interest in excess of 12 percent per annum,

compounded semi-annually, on the outstanding loan balance (principal and accrued but unpaid interest) is includible in the income of the person to whom payment is to be made no later than the last day of such taxable year of the payor taxpayer.

(e) *Applicability date*. Paragraph (d) of this section applies to taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER].

Par. 3. Section 1.267(b)-1 is amended by revising paragraph (b) to read as follows:

§ 1.267(b)-1. Relationships.

* * * * *

(b) *Applicability date*. This section applies to taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER].

Par. 4. Section 1.707-1 is amended by:

1. Removing the language "partner" in paragraph (b)(1)(i) and adding the language "person" in its place;

2. Removing the language "the provisions of subdivision (i) of this subparagraph," in paragraph (b)(1)(ii) and adding the language "paragraph (b)(1)(i) of this section," in its place;

3. Adding new paragraph (b)(1)(iii);

4. Removing the language "partner" in paragraph (b)(2) and adding the language "person" in its place;

5. Removing the language "80 percent" in the first and second sentences of paragraph (b)(2) and adding the language "50 percent" in its place; and

6. Revising paragraph (b)(3).

The additions and revision read as follows:

§1.707-1 Transactions between partner and partnership.

* * * * *

(b) * * *

(1) * * *

(iii) For purposes of matching deductions and income in the case of expenses and interest under section 267(a)(2), two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests in each partnership will be treated as persons specified in section 267(b).

* * * * *

(3) *Ownership of a capital or profits interest*. For the purpose of applying section 707(b), the rules for constructive ownership of stock provided in section 267(c)(1), (2), (4), and (5) apply in determining the extent to which a capital interest or profits interest in a partnership is owned, directly or indirectly, by any person, including a person who does not own a partnership interest prior to application of 267(c). For example, where trust T is a partner in the partnership ABT, and AW, A's wife, is the sole beneficiary of the trust, the ownership of a capital and profits interest in the partnership by T will be attributed to AW both for the purpose of further attributing the ownership of such interest to A and for determining whether AW is a constructive owner of an interest in the partnership. See section 267(c) (1), (2), and (5). Accordingly, if A, B, and T are equal partners in ABT, because AW is treated as constructively owning the one-third capital and profits interest in ABT owned by T and AW’s ownership is attributed to A, A will be considered as owning a more than 50 percent capital and profits interest in ABT, and a loss sustained by A on a sale or exchange of property with ABT will be disallowed by section 707(b)(1)(A). Similarly, because AW is treated as constructively owning the one-third capital and profits interest in ABT owned by T and is attributed the ownership of A’s capital and profits interest in ABT, AW will be considered as owning a more than 50 percent capital and profits interest in ABT and a loss sustained by AW on a sale or

exchange of property with ABT would also be disallowed by section 707(b)(1)(A).

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Par. 5. Section 1.707-9 is amended by:

1. Revising the section heading;
2. Redesignating paragraphs (a) and (b) as paragraphs (b) and (c); and
3. Adding new paragraph (a).

The addition and revision read as follows:

§1.707-9. Applicability dates and transitional rules.

(a) *Section 1.707-1*. Paragraphs (b)(1)(i) through (iii), (b)(2), and (b)(3) of §1.707-1 apply to sales or exchanges of property with respect to controlled partnerships in taxable years ending on or after [DATE OF PUBLICATION OF FINAL RULE IN THE FEDERAL REGISTER].

* * * * *

Douglas W. O'Donnell,

Deputy Commissioner for Services and Enforcement.

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